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Supreme Court, U.S.
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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1987

JAMES POLAKOF, ROY C. PETERSON, LEE E. SCHWARTZ, VERA J. SCHWARTZ, ROMAN J. and LORRAINE A. OLEYNIK, DAVID and FRANCES STEVENSON, ARLIN BLACKWELL and SHARON BLACKWELL, MICHAEL A. BAKER, SUE B. BAKER, LEONARD A. VINCI, KEN B. TEAKLE, MARILYN L. TEAKLE, JOHN FERRERI, JUNE FERRERI, DEAN S. MERRICK, MARILYN MERRICK, FRANCIS X DRISCOLL, PATRICIA B. DRISCOLL,

Petitioners-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On a Writ of Certiorari from the Court of Appeal for the Ninth Circuit

Petition for Certiorari

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September 16, 1987

QUESTIONS PRESENTED

Special and important questions of Federal tax law presented for review are:

1. Whether a "predominate" motive test applied by the Tax Court in determining profit motive in tax advantaged motion picture partnerships was clearly in error.

2. Whether partnership promissory notes represented bona fide indebtedness.

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PARTIES TO PROCEEDING BELOW

All parties involved appear in the caption of the case as set forth above.

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IN THE

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OCTOBER TERM 1987

JAMES POLAKOF, ROY C. PETERSON, LEE E. SCHWARTZ and VERA J. SCHWARTZ, ROMAN J. and LORRAINE A. OLEYNIK, DAVID and FRANCES STEVENSON, ARLIN BLACKWELL and SHARON BLACKWELL, MICHAEL A. BAKER, SUE B. BAKER, LEONARD A. VINCI, KEN B. TEAKLE, MARILYN L. TEAKLE, JOHN FERRERI, JUNE FERRERI, DEAN S. MERRICK, MARILYN MERRICK, FRANCIS X. DRISCOLL, PATRICIA B. DRISCOLL,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent-Appellee.

On a Writ of Certiorari from the Court of Appeals for the Ninth Circuit

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PETITION FOR CERTIORARI

The petitioners herein respectively pray that a writ of certiorari issue to review the Ninth Circuit affirmance of a decision of the United States Tax Court, which Ninth Circuit amended decision was filed June 30, 1987. (The initial decision of the Ninth Circuit Court of Appeals was filed June 22, 1987), No petition for rehearing was filed.

OPINIONS BELOW

The decision of the United States Tax Court in James Polakof, et al., v. Commissioner of Internal Revenue, was filed April 23, 1985. The case is reported by CCH at T.C. MEMO 1985-197, 49 T.C.M. 1300 (1985). The Tax Court and the amended and original Ninth Circuit opinions are printed in Appendix A, B and C hereto. A petition for rehearing was not filed.

JURISDICTION

This case involves an issue of first impression for this Court with respect to federal tax law. Jurisdiction to review the determination of the Ninth Circuit Court of Appeals is conferred by Article III of the United States Constitution. This petition was mailed to the Court within 90 days of the filing date of the Ninth Circuit decision on June 22, 1987, as extended by the September 19, 20 weekend.

STATUTORY PROVISIONS INVOLVED

Sections 48(a)(1), 162(a), 163(a)(1), 167(a)(1) 183 of the Internal Revenue Code of 1954.

Section 48(a)(1) allows an investment credit with respect to property for which depreciation (or amortization is allowable).

Section 162(a) allows for the deduction of expenses in carrying on a trade or business.

Section 163(a) allows for an interest deduction on genuine indebtedness.

Section 167(a)(1) allows for depreciation for property used in a trade or business.

Section 183 [and the Treasury Regulations thereunder, 1.183-2(b)] deals with activity engaged in for profit.

STATEMENT OF THE CASE

The relevant facts of this case are set forth as follows:

(A) Course of proceeding in the case before the Court.

This case arose upon petitions to the United States Tax Court. The Tax Court opinion was filed in 1985 and certain issues were appealed to the Ninth

Circuit. The Tax Court was affirmed. The Ninth Circuit had jurisdiction of the appeal under IRC section 7482(a)

(B) Relevant facts concerning questions presented.

In and about 1973 Cinema Financial of America, a California corporation, was formed. The corporation is hereinafter referred to as CFA, Inc. The initial organizers, shareholders and officers were James Polakof, president and chairman of the board, Reginald Olsen, executive vice-president (finance), Ronald Peck, vice-president and treasurer, and Denver Sutton, vice-president (TR 132-133).

James Polakof is a graduate of the University of San Francisco and is presently a motion picture and television producer, director and writer. Several of his recent pictures involve major name actors and actresses. After college he

formed and operated his own advertising agency for about 11 years during which time he was primarily involved in the production and marketing of over 100 commercials. He also produced industrial and documentary films, one of which starred "Eddie Albert" and ran for an hour. Polakof wrote, directed and produced such films. In 1971, he joined Systech which was owned by "Dillingham Corporation". Systech was involved in real estate and apartment syndication. Polakof was in charge of marketing.

Reginald Olsen was one of the founders of Systech and had long standing experience in finance and investment.

Ronald Peck was one of the top financial people at Systech.

Denver Sutton had experience in production of motion pictures through his corporation, Studio 16.

CFA Inc. was to function as the organizer and general partner of limited partnerships which were to acquire and distribute motion pictures for profit. (TR 128-129).

CFA Inc.'s principal approach conceptually in distributing films and acting as general partner of CFA limited partnerships to be formed was to penetrate the motion picture exhibition market by utilizing a distribution technique know as "four-walling". (TR 187-188; also see, Exhibits 155(2), 167).

"Four-Walling" is a term used to describe a means of distribution whereby the distributor rents theater space "fixed cost" and heavily advertises the motion picture. It was an innovative device in order to allow independents to exhibit films. During 1972 through 1974, four-wallers were making very large

profits. (TR 188, 193-197; Exhibits 155(2), 167).

In and about mid-1973, CFA Inc. commenced organizing, as general partner, several limited partnerships to contract for production of a particular motion picture and upon completion to distribute the film for profit. The partnerships formed that are in issue in this case are CFA I, IV, V and VII. CFA Productions Inc. was a California corporation formed to produce motion pictures, (entire record).

In mid 1973 CFA Inc. formed CFA I, as a California limited partnership, and prepared a prospectus for investor consideration. The limited partnership was capitalized at $350,000, with $200,000 to be secured by initial cash contributions (1973) and the balance to be secured through deferred payment (1974) pursuant to subscription

agreements and promissory notes. The partnership was fully capitalized. (Stipulation paragraph 15; Exhibits 117-DM, 126-DV, 129-BX-et seq. and 157).

CFA I agreed to purchase the film "Cry in the Wilderness" (later the name was changed to "Silence") for $625,000, $125,000 of which was to be paid in cash and $500,000 by promissory note. The film was to be delivered via a 35mm negative. $125,000 was in fact paid to Studio 16 in 1973. (Stipulation, paragraph 12; TR 195-196, 279-285, 375-384; Exhibits 121-DQ, 125-DM and 190).

The film "Silence" involves the story of an autistic child lost in the wilderness. The film involved the well recognized actor Will Geer. The film was arranged to be directed by John Korty, a director gaining in prominence, and also included Hiro Nirita, a highly respected cinematographer. The film had its own

musical score and was a quality production. It was designed to compete with Disney Films as a G-rated picture. It received several awards. (TR 170-180; Stipulation, paragraph 18: Exhibits 132-et seq.).

In 1974 CFA Inc. undertook an intensive campaign to "four-wall" "Silence". (TR 196-199, 338-358 and 386).

CFA I reported the following net income from exhibition of "Silence". (In 1974, the film gorssed over six million dollars.)

CASH RECEIPTS

1973	$100.00
1974	605,362.00
1975	18,567.00
1976	15,912.00
1977	3,802.00

[Exs. 1973-99-CV, 1974-100-CV, 133-EB (journal and ledger account 301),

Exs. 1975-101-CW, 1976-102-CX, 1977-103-CY].

In late 1973 CFA Inc. formed CFA IV, as a California limited partnership, and prepared a prospectus for investor consideration which is dated March 13, 1974. The limited partnership was capitalized at $525,000, with $210,000 to be secured in 1974 by initial cash contirbutions and the balance to be secured later in 1974 pursuant to subscription agreement and promissory note. The partnership was capitalized at $420,000. (Stipulation paragraph 15; Exhibits 118-Dn, 144-EM et seq.)

By sales agreement dated March 1974 between CFA IV and CFA Productions, Inc., CFA IV agreed to purchase the film "He is My Brother" for $1,425,000, $225,000 of which was to be paid in cash and $1,200,000 by promissory note. $225,000 was in fact paid to CFA

Productions, Inc. in 1974. (Stipulation paragraph 23; TR 195-196, 279-285, 378-384; Exhibits 137-EF, 190).

The film "He is My Brother" involves the story of two young boys shipwrecked on Molakai at the turn of the century and the plot involves confrontations with the evil "Kahuma". The film involved the well recognized character actor Keenan Wynn and Boby Sherman, a very popular singing star. The film was directed by Edward Dmytryk, a very famous director who directed the film "Caine Mutiny". The film has its own musical score and was a quality production. It was designed for a general audience. (TR 206-211; Stipulation paragraph 29; Exhibit 1c12-EK; 170.)

In 1974 and 1975, CFA, Inc. undertook an intensive campaign to distribute "He is My Brother". CFA Inc.

went to theater chains such as United Artists and Feneral Cinema Theaters and secured some exhibitions, (See Exhibit 143-EL) but due to CFA Inc. financial problems, it did not have funds to pursue the distribution and the film was turned over to Manson International to distribute. Manson did produce revenues. (TR 211-212, 221-228, 348-349; Exhibit 171.)

In late 1973 CFA Inc. formed CFA V, as a California limited partnership. The limited partnership was capitalized at $525,000, with $210,000 to be secured in 1974 by initial cash contributions and the balance to be secured later in 1974 by initial cash contributions and the balance to be secured later in 1974 and 1975 pursuant to subscription agreement and promissory note. The partnership was capitalized at $420,000. (Stipulation paragraph 48; Exhibits 158-FA(a) et seq.)

By sales agreement dated in March 1974 between CFA V and CFA Productions, Inc., CFA V agreed to purchase the film "Sunburst" for $1,425,000, $225,000 of which was to be paid in cash and $1,2000,000 by promissory note. $225,000 wa, in fact, paid to CFA Productions, Inc. in 1974. (Stipulation paragraph 31; TR 195-196, 279-285, 378-384; Exhibits 123-DS, 190.)

The film "Sunburst" involves the story of two college students searching for direction in their lives. They are attacked by two misfits who stalk them as prey. The film stars several up and coming stars, including Peter Hooten and Kathy Baumann. The film also stars Rudy Vallee, a long time favorite actor and singer.

CFA V reported the following income from exhibition of "Sunburst":

	CASH RECEIPTS
1974	$ 50.00
1975	7,766.00
1976	2,336.84
1977	1,461.25

(Exhibits 151-ET, 108-DD, 109-DE, 110-DF and 111-DG.)

In late 1973 CFA, Inc. formed CFA VII, as a California limited partnership. The limited partnership was capitalized at $125,000, with $70,000 to be secured in 1974 by initial cash contributions and the balance to be secured later pursuant to subscritption agreement and promissory note. (Stipulation paragraph 15; Exhibits 118-DN, 144-EM et seq.)

By sales agreement dated in March 1974 between CFA VII and CFA Productions, Inc., CFA VII agreed to purchase the film "Movie Star" for $125,000 of which $35,000 was to be paid in cash and $90,000 by promissory note.

$25,000 was, in fact, paid to CFA Productions, Inc. in 1974. (Stipulation Paragraph 34; Exhibits 120-DP, 124-DT, 152-EM).

The film "Movie Star" is a film describing how to break into motion pictures. It was to be shown with other CFA films with a percentage paid to the CFA VII partnership. It had a built in profit factor. Over 200 35mm prints were made and at a cost of approximately $60,000. The film was completed and commercially exhibited in 1974. (TR 227-236).

The petitioners in the several partnerships claimed as deductions as limited partners parthership loss from business expenses, depreciation, and investment tax credit.

ARGUMENT I

The Tax Court erred as a matter of law in applying a standard requiring that profit objective be "predominant", "primary" or "principal":

The fundamental issue in this case was "profit motive" and, in particular, the legal standard to be applied in determining such. Other issues raised as grounds for disallowing all or part of the claimed deductions or credits were not reached in that the Court held that the partnerships were not carrying on a trade or business. (Tax Court Opinion, Footnote 3.)

The legal standard concerning profit motive was stated by the Tax Court as follows:

> "A partnership activity does not constitute a trade or business unless the partnership engages

> in the activity with the predominant, primary or principal objective of making a profit. Flowers v. Commissioner, supra at 931; Siegel v. Commissioner [63-1 USTC ¶ 9371], 315 F. 2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court [Dec. 25,021(M)]; Lemmen v. Commissioner [Dec. 38,510], 77 T.C. 1326, 1340 (1981). We must, then, decide whether realizing a return on the investors' capital or providing the investors with tax benefits was the predominant objective of the partnerships. 66 T.C. 312, 319, 321."

Petitioners argued on appeal that the Tax Court standard requiring that profit motive be "predominant, primary or principal" is incorrect. Petitioners further argued that IRC section 183 and the regulations thereunder which the Courts look to as an operative section in determining profit motive do not define motive in such terms. Petitioners argued that the proper test is whether the motive in making a profit was actual, honest and

bona fide even if the expectation was not reasonable. [TR 1.183-2(b)]; Surloff v. Commissioner, 81 T.C. 210(1983) and Dreicey v. Commissioner, 78 T.C. 642(1982).

The Circuit Court completely failed to address petitioners argument that the proper test is honest and bona fide profit objective and dismissed petitioners argument concerning the Tax Court's use of terms such as "predominant", "primary" and "principal" as being without significance. See Foot note 2 - Ninth Circuit Opinion. The Circuit Court and the Tax Court cited and relied upon the 1963 Ninth Circuit case of Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963) which stated that profit motive must be "dominant".

The Tax Court's standard, approved by the Circuit, means that profit objective must be first and

foremost as a motive for engaging in an activity in order to constitute the carrying on of a trade or business. Profit motive is a fundamental issue in virtually every tax shelter case. Thousands upon thousands of tax shelter cases are in litigation.

First, the Hirsch case, does not state that motive must be the most basic or most dominant of all the motives that may be involved. Hirsch predates the enactment of IRC Section 183 and, if Congress had wished to impose a predominant - principal purpose test, it could have expressly done so. It has done so in other code provisions. See for example IRC Sections 269 and 357. It did not do so here. The omission strongly suggests that Congress did not intend such a test under Section 183.

It appears that the predominant objective test began to more fully emerge

in Jasionowski v. Commissioner, 66 T.C. 312, 319-322 (1976) and to be superimposed by the Court on IRC Section 183. The principal purpose test is repeated in a long series of Tax Court cases. See progressively, Dunn v. Commissioner, 70 T.C. 715, 720 (1978); Allen v. Commissioner, 72 T.C. 659, 666 (1979); Flowers v. Commissioner, 80 T.C. 914 (1983); What was early expressed as a dominant motive in Hirsch, supra, has been become a predominant motive. However, Note in Judge Simpson's recent opinion in Drobny v. Commissioner, 86 T.C. 1326 (1986) the term "predominant" motive does not appear. Also see, Churchman v. Commissioner, 68 T.C. 696 (1977) where profit motive is not characterized quantitatively. It obviously can be determinative in deciding a case whether a profit objective must be viewed as predominant

or, in other words, first and foremost. See Webber v. Commissioner, T.C. Memo 1983-633 pointing to the semantic confusion. Also see Cooper, Taming of the Shrewd, 85 Columbia Law Review, 656, 683 (1985). Compare the Tax Court case of Baigent v. Commissioner, 53 T.C.M. CCH 1221 (1987) with the Polakof Tax Court Case. Baigent is a tax shelter case similar to Polakof, and in the opinion the test used is actual and honest profit objective. No mention is made of dominant motive. Not only are different judges in the Tax Court applying different standards, e.g., Polakof, supra; Baigent, supra, but in tax shelter cases now proceeding through the appellate Courts, the Courts are applying different standards with respect to dominate (predominate) motive vis-a-vis honest and bona fide motive. Compare: Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1974); Baron v.

Commissioner, 798 F.2d 65 (2d Cir. 1986); Cornfeld v. Commissioner, 797 F.2d 1049 (DC CA) 1986; Deegan v. Commissioner, 787 F.2d 825 (2nd Cir. 1986), also note Berger v. Commissioner 87-1 USTC ¶ 9137 (7th Cir. 1987).

In Johnson v. United States, 86-2 USTC ¶ 9705, (Ct. Cl. 1986), the Court of Claims describes at length the question of the proper standard concerning profit motive in a business context and concludes that the "primary and dominate" test is not appropriate in a business context.

In summary, it is clear that the different Courts are applying varying standards for profit motive in tax cases and this is an appropriate case for the Supreme Court to pass on the correct standard.

In recent years the Supreme Court has not been reluctant to define

legal standards in tax cases. See For Example, United States v Generes, 405 U.S. 93 (1972) where the Court determined that a dominant motive vis-a-vis a significant motive was necessary to qualify a loss as a business bad debt. Also note Malat v. Riddell, 383 U.S. 569 (1966) determining that "primarily" held for sale means "of first importance" or "principally" under Section 1221 (1) of the Internal Revenue Code of 1954.

ARGUMENT II

Whether promissory notes represented bona fide indebtedness.

The Ninth Circuit affirmed the Tax Court holding that the promissory notes on purchase of the films by the partnerships do not represent bona fide indebtedness.

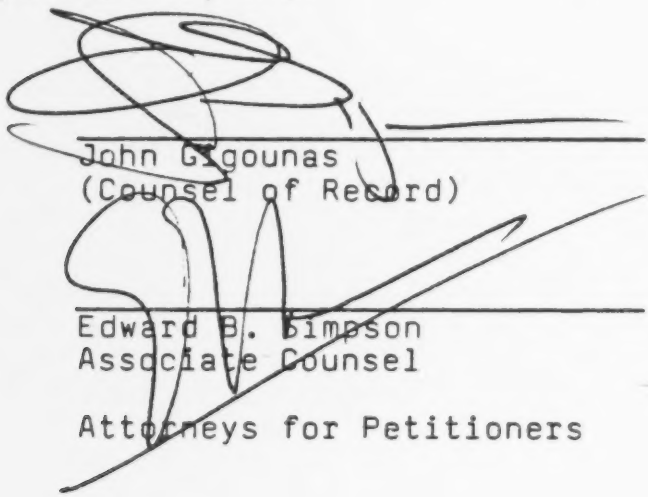
Petitioners contend that application of the incorrect profit

motive standard prejudiced the Courts view of the underlying indebtedness and if this case were to be remanded the bona fides of the notes must be reconsidered.

CONCLUSION

The Supreme Court should grant the writ requested herein.

Dated: September 16, 1987



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[CCH Dec. 42,046(M)]

JAMES POLAKOF, ET AL.[1] v. COMMISSIONER.

Docket Nos. 4777-80, 13875-80, 15666-81, 20512-81, 25657-81, 25658-81, 25659-81, 29625-81, 29626-81, 29627-81, 29629-81, 29630-81, 30040-81, 31015-81, 1764-82, 1765-82.

T.C. Memo 1985-197.

Filed April 23, 1985.

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1 The following cases are consolidated herewith: Roy C. Peterson, docket No. 13875-80; Clarence H. Steinhebel and Gertrude Steinhebel, docket No. 15666-81; Lee E. Schwartz and Vera J. Schwartz, docket No. 20512-81; Michael A. and Sue B. Baker, docket No. 25657-81; Leonard A. Vinci, docket Nos. 25658-81 and 25659-81; Ken B. and Marilyn K. Teakle, docket No. 29625-81; George P. and Ramona T. Golf, docket No. 29626-81; Roman J. and Lorraine A. Oleynik, docket No. 29627-81; John and June Ferreri, docket No. 29629-81; Dean S. Merrick and Marilyn Merrick, docket No. 29630-81; Francis X. Driscoll and Patricia B. Driscoll, docket No. 30040-81; William and Carol Talty, docket No. 31015-81; David and Frances Stevenson, docket No. 1764-82; Arlyn and Sharon Blackwell, docket No. 1765-82.

Edward B. Simpson, 50 California St., San Francisco, Calif., for the petitioners. Theodore Garelis, for the respondent.

Memorandum Findings of Fact and Opinion

Featherston, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Petitioners	Docket No.	Year	Deficiency
James P. Polakof	4777-80	1974	$ 2,283.00
		1975	534.00
Roy C. Peterson	13875-80	1976	627.00
Clarence H. Steinhebel and Gertrude Steinhebel	15666-81	1971	1,328.89
		1972	1,566.00
		1973	606.11
		1974	3,261.00
		1975	1,273.00
		1976	663.00
		1977	449.00
Lee E. Schwartz and Vera J. Schwartz	20512-81	1973	4,684.00
		1974	8,065.00
		1975	2,513.00
		1976	2,661.00
		1977	560.00

Petitioners	Docket No.	Year	Deficiency
Michael A. and Sue B. Baker	25657-81	1971	$ 1,565.90
		1972	1,497.00
		1973	3,674.00
		1974	2,884.00
		1975	3,088.00
		1976	2,396.00
		1977	397.00
Leonard A. Vinci	25658-81	1976	1,415.00
		1977	1,776.00
Leonard A. Vinci	25659-81	1973	4,091.00
		1974	8,051.00
		1975	16,558.00
Ken B. and Marilyn K. Teakle	29625-81	1971	2,075.00
		1973	3,208.00
		1974	880.00
		1975	3,216.00
		1976	1,147.00
George P. and Ramona T. Golf	29626-81	1974	2,271.90
		1975	553.46
		1976	289.44
		1977	460.00
Roman J. and Lorraine A. Oleynik	29627-81	1974	9,864.00

Petitioners	Docket No.	Year	Deficiency
John and June Ferreri	29629-81	1973	$ 1,037.00
		1974	1,455.00
		1975	3,040.00
		1976	856.00
		1977	1,478.00
Dean S. Merrick and Marilyn Merrick	29630-81	1973	8,554.00
		1974	8,029.00
		1975	11,857.00
		1976	5,623.00
		1977	775.00
Francis X. Driscoll and Patricia B. Driscoll	30040-81	1976	4,647.00
		1978	3,089.00
William and Carol Talty	31015-81	1974	4,842.00
		1975	1,570.00
		1976	507.00
		1977	511.00
David and Frances Stevenson	1764-82	1974	2,522.00
		1975	1,021.00
		1976	362.00
		1977	204.00
Arlyn and Sharon Blackwell	1765-82	1973	2,261.39
		1974	4,559.00
		1975	3,015.00
		1976	1,143.00
		1977	1,651.00

The tax liabilities in dispute arise from each of the petitioners' involvement in one or more limited partnerships, CFA Investors I, CFA Investors IV, CFA Investors V, and CFA Investors VII. Each of these partnerships acquired and distributed a motion picture and reported losses and investments for tax credit purposes which were passed through to the limited partners. The correctness of respondent's disallowance of these deductions and credits produced the determined deficiencies and turns on the following issues:

1. Whether the partnerships' activities with respect to the motion pictures constituted a trade or business; the answer determines whether petitioners are entitled to deductions for losses attributable to deductions for business expenses and depreciation claimed under

sections 162(a)[2] and 167(a) and investment credits under section 38 and related sections which were passed through the partnerships to them for the years 1973, 1974, 1975, and 1976; and

2. Whether nonrecourse notes given by the partnerships as part of the consideration for the motion pictures were genuine indebtedness; the answer determines the allowability of interest deductions claimed by the partnerships and included in the loss deductions passed through to the partners.[3]

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2 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

3 Respondent has raised a number of other issues as grounds for denying all or part of the claimed deductions, including failure to substantiate some of the alleged expenditures claimed as deductions; that prepaid management fees were start-up expenses which must be capitalized; that the nonrecourse notes may not be included in basis for depreciation or investment credit

Findings of Fact

At the time the petitions in these consolidated cases were filed, all of the petitioners were legal residents of California.

Facts Common to All Partnerships

Cinema Financial of America, Inc. (CFA), a California corporation, was the general partner of each of four limited partnerships, designated CFR Investors I, CFA Investors IV, CFA Investors V, and CFA Investors VII. To promote the sale of limited partnership interests, CFA published a prospectus for each partnership entitled "A Private Offering of Limited Partnership Interests."

The prospectus on CFA Investors I declares that:

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[3] purposes; that the depreciation method used by the partnerships was not a proper one. We find it unnecessary to consider these arguments.

The principal objective of the Partnership are to maximize the distributed return on investors' capital and to provide investors with significant Federal Income Tax deductions in the first year through the vehicle of a feature length motion picture.

Similar statements appear in each of the prospectuses on the other partnerships.

The prospectuses describe a close relationship between CFA as general partner and the organizations with which the partnerships were to deal. In the case of CFA Investors I, the motion picture was to be acquired from Studio 16, Inc. (Studio 16), the producer. Denver Sutton, a vice-president of CFA, was also Chief Executive Officer and the majority stockholder of Studio 16. Petitioner James Polakof (Polakof), president, director, and stockholder of CFA had been retained by Studio 16 as an independent contractor and management consultant from time to time.

In the case of the other three

partnerships, the movies were to be produced by CFA Productions, Inc., and marketed by CFA Marketing, Inc.;[4] both of these corporations were wholly owned subsidiaries of CFA. All of those entities were represented by the same law firm.

Studio 16 had no experience in making feature films; it specialized in making documentary and industrial films. Studio 16 ultimately "more or less became an integral part of the C.F.A. operation." CFA Productions had made no other films of any kind prior to its involvement with the CFA movies. The CFA Investors I prospectus states that, although this was CFA's "first partnership" venture, "the officers and directors of CFA have individually had considerable experience in limited partnership investment vehicles and, in some cases, motion picture production."

Attachments to the prospectuses included as exhibits copies of the agreements of limited partnership to be entered into by CFA and the limited partners; a copy of the contract of sale of the particular motion picture to the partnership; financial projections; projected investment results; a legal opinion that each partnership was entitled to be treated as such rather than as an association taxable as a corporation; and a subscription agreement form. An exhibit to the CFA Investors IV prospectus describes the income tax benefits as follows:

INCOME TAX BENEFITS
Equivalent Percentage First Year Tax Write-Off = 95%
Potential income tax benefits

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4 The prospectus on CFA Investors VII does not specifically mention CFA Marketing, Inc., but states that the film "will be exhibited as a 'featurette' on the same program with one of CFA's feature-length motion pictures."

for a motion picture investment are somewhat more complex than those from many other types of investments. For instance, an investment in an apartment project will usually result in tax benefits because the ttal sum of expenses plus depreciation is greater than the collected income. The resulting "paper loss" (usually called "write-off") may then be used to offset other sources of income, thereby resulting in a smaller tax bill.

A properly structured motion picture investment also has write-off similar to the above example. But, in addition, it offers a second source of tax benefits through a device known as "investment tax credit". If a motion picture has a useful life of seven years or more, 7 percent of its cost may be taken as an investment tax credit and

deducted directly from the federal, and in some cases state, tax bill of the owner of the picture. This is obviously a particularly valuable tax benefit because it results in a dollar-for-dollar reduction in the tax bill itself; whereas write-offs only reduces the taxable income and is therefore of decreasing benefit for lower tax brackets.

For the purpose of simplicity in determining the value of investing in this partnership, the tax benefits from both write-offs and investment tax credit have been combined into one overall hypothetical number based upon an investor in the 50-percent tax bracket. This number indicates that the potential income tax benefit in 1974 is equivalent to that of a write-off of approximately 95 percent on all capital contributed this year.

The prospectuses explain that the partnerships' payments to CFA may include prepayments of interest of management fee, and other advertising, promotion, and distribution costs in addition to the price of the motion picture. The price of each of the motion pictures was stated in the respective prospectuses nad was not a matter of negotiation between CFA and the partnerships or CFA and the limited partners.

Each partnership agreement provided that the partnership would expire on December 31, 1980, unless partners holding 100 percent of the outstanding units voted in favor of continuation. No steps were taken to extend the partnerships.

None of the partnerships made any cash distributions to their respective partners Nor did any of them

make any payments on the principal of the nonrecourse note to CFA.

CFA Investors I - "Silence"

CFA Investors I was formed on April 16, 1973. An ammendment to a certificate of limited partnership dated April 30, 1974, lists 21 limited partners who invested a total amount of $350,000. Eight of the 21 limited partners in this partnership are petitioners in this proceeding; 13 are not.[5]

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[5] These counts of the number of limited partners treat a husband and wife as separate partner. The following petitioners invested in CFA Investors I:

Partner	Amount Invested
Michael A. Baker	$ 15,000
Arlyn Blackwell, et ux	10,000
John Ferreri	10,000
Dean S. Merrick	30,000
Roy C. Peterson	10,000
Lee E. Schwartz	15,000
Leonard A. Vinci	15,000
Ken B. Teakle	10,000

On April 16, 1973, the same day it was formed, CFA Investors I entered into a contract of sale calling for Studio 16 to produce and sell to CFA Investors I a motion picture entitled "A Cry in the Wilderness," the name of which was later changed to "Silence." Under the terms of the contract, the stated purchase price was $625,000, composed of a cash payment of $125,000 and a nonrecorse note in the amount of $500,000, bearing interest at the rate of 9 percent per annum and payable out of 40 percent of the net receipts form the motion picture "Silence." The outstanding balance on the note was to become due and payable on December 31, 1980, and, in the event of default, Studio 16 was given the right to foreclose on the motion picture. Subsequently, Denverr Sutton, Chief

Executive Officer and majority stockholder of Studio 16, became a shareholder in CFA, and he brought with him to CFA the Studio 16 facilities. Polakof was the producer of "Silence." He had no experience in making feature films before he began to produce the CFA movies. His background was in the fields of advertising and marketing. He had some experience in television commercials and industrial films. Before he set up these four partnerships, he had been involved in marketing and selling real estate investments via limited partnerships.

Similarly, neither the script writer nor the individual identified as the director had previously written or directed commercially successful feature films. Apart from one actor, Will Geer, the cast had little screen experience.

As a general rule, experienced and well-known writers, directors, and casts are important in the marketing of films because theater owners tend to select films identified with individuals who have known performance records.

Polakof informed the crew and technical staff working on "Silence" that it had to be finished and had to play somewhere, in any condition, before Decemberr 31, 1973, for tax reasons. Polakof instructed the crew and staff that the quality of the film did not matter and that heavy advertising would "get the people in the theater."

"Silence" was in fact completed in December 1973 and was shown before the end of the year. The actual cost of producing "Silence" was $105,000 compared with average production costs at Metro-Goldwyn Mayer during 1972 and 1973, for example of approximately $2,000,000.

Higher budget films, as a rule, have a better chance of success than do low budget films because a higher budget permits a producer to obtain the services of actors and technicians with more experience and talent.

Compared with the stated purchase price of $625,000, "Silence" had no fair market value for theatrical purposes and a maximum fair market value of $30,000 for network television and other ancillary markets.

Polakof attempted to market "Silence" by using a technique known as "four-walling." This technique calls for the distributor to rent several theaters in a local area for an agreed period and to use local television, radio, and newspapers to advertise heavily the movie to be shown during that period. A distributor's risk in using the four-walling technique is much greater than

more conventional distribution arrangements because of the required commitments for theater rentals and advertising expenses.

Four-walling of "Silence" was tried in Hawaii, Dallas, and Los Angeles but the movie was not a box office success. The following table shows the gross receipts, losses, depreciation, interest, and miscellaneous expenses of CFA Investors I as reported in its partnership returns for 1973 through 1977:

Year	Gross Receipts	Losses
1973	$ 100	$155,098.33
1974	605,362	492,841.00
1975	18,567	140,517.00
1976	15,912	99,250.00
1977	3,802	21,154.00

Year	Depreciation	Interest
1973	$ 5.21	$ 35,000
1974	210,000.00	5,704
1975	116,044.00	0
1976	99,250.00	0
1977	21,154.00	0

Year	Other Deductions
1973	$120,193.12
1974	882,495.00
1975	43,040.00
1976	12,377.00
1977	837.00

The deductions for 1973 include prepaid interest of $35,000 to Studio 16 and a management fee of $45,000. Depreciation was computed under the income forecast method using a cost basis of $625,000 and estimating gross receipts of $12,000,000. Attached to the partnership returns are schedules K-1 showing the amounts of losses and the basis for investment tax credits passed through to the limited partners.

CFA Investors IV - "He Is My Brother"

CFA Investors IV was formed as a limited partnership in december 1973. The Amendment to Certificate of Limited Partnership of CFA Investors IV lists 34 limited partners, nine of whom are

petitioners in this proceeding.[6] The total amount invested by the 34 limited partners was $525,000.

On March 15, 1974, CFA Investors IV entered into a contract of sale with CFA, whereby CFA agreed to produce and to sell to CFA Investors IV a motion picture entitled "He Is My Brother." The price of the picture was $1,425,000 and was to consist of cash in the amount of $225,000 and a nonrecourse note for the balance of $1,200,00. The note was to bear interest at the rate of 10 percent per annum and

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6 The petitioners involved in CFA Investors IV and the amounts of their investments are as follows:

Partner	Amount Invested
Michael A. Baker	$ 15,000
Roy C. Peterson	15,000
Arlyn N. Blackwell, et ux	15,000
Dean S. Merrick, et ux	22,500
Ken B. Teakle, et ux	15,000
Leonard A. Vinci	15,000
John P. Ferreri, et ux	7,500
William J. Talty	15,000
Roman J. Oleynik	15,000

was to be payable out of 40 percent of the net receipts from the motionpicture. The note was to become due December 31, 1980, and was to be secured by a lien on the movie.

CFA undertook to distribute "He Is My Brother" by the more traditional percentage method whereby CFA shared the screening proceeds with the theater owner on a percentage basis. The film was commercially exhibited in 1974. In 1974 and 1975, CFA went to theater chains such as United Artists and General Cinema Theaters and secured some exhibitions. The film was finally turned over for distribution to Manson International, a film distributor, but it has not had much success.

Compared with a stated purchase price of $1,425,000, "He Is My Brother" had a fair market value of not more than $12,500 for theatrical exhibition

purposes and not more than $50,000 for network television and other ancillary markets.

The following table shows the gross receipts, losses, depreciation, interest, and other deductions reported by CFA Investors IV for 1974 through 1977:

Year	Gross Receipts	Losses
1974	50	210,361
1975	11,837	202,469
1976	4,553	39,649
1977	3,802	30,500

Year	Depreciation	Interest
1974	$ 24	$ 80,000
1975	57,217	103,254
1976	39,649	0
1977	33,109	0

Year	Other Deductions
1974	$130,387
1975	53,835
1976	4,553
1977	837

A schedule attached to the 1974 partnership return shows that the "other deductions" included a $60,000 management fee. The partnership used a cost basis of $1,450,000 for the motion picture. Attached to the partnership returns are schedules K-1 for each partner documenting the pass-through of the reported losses and the basis of the movie for investment tax credit purposes.

CFA Investors V - "Sunburst"

CFA Investors V was organized as a limited partnership in December 1973. An Amendment to Certificate of Limited Partnership dated April 8, 1975, lists 33 limited partners who invested a total amount of $525,000 in the limited partnership. Five of the 33 limited partners in the partnership are

petitioners[7] in this proceeding; 28 are not.

On June 10, 1974, CFA Investors V entered into a contract of sale with CFA providing for the future production and sale by CFA of a motion picture entitled "Sunburst." The stated purchase price of the movie was $1,425,000 composed of a cash payment of $225,000 and a nonrecourse note of $1,200,000 bearing interest at the rate of 10 percent per annum payable out of 40 percent of the net receipts from the motion picture. The note was to become

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7 The following partners are petitioners in this proceeding:

Partners	Amount Invested
Roman J. Oleynik	$ 15,000
Francis K. Driscoll, et ux	15,000
Clarence M. Steinhebel, et ux	22,500
David Stevenson	7,500
George P. Golf	7,500

due on December 31, 1980, and was secured by a lien on the movie.

CFA completed the production of "Sunburst" and delivered it in 1974. The movie was exhibited before the end of the year. Records no longer exist with respect to the actual cost of production. CFA attempted to distribute "Sunburst" using the percentage method but did not succeed. This film also was eventually turned over for distribution to Manson International.

Compared with a stated purchase price of $1,425,000, "Sunburst" had no fair market value for theatrical exhibition purposes and not more than $25,000 for network television and other ancillary purposes.

The following table shows the gross receipts, losses, depreciation, interest, and miscellaneous expenses of

CFA Investors V for 1974 through 1977:

Year	Gross Receipts	Losses
1974	50	249,192
1975	7,766	182,907
1976	2,337	56,272
1977	1,461	34,911

Year	Depreciation	Interest
1974	$ 24	$ 80,000
1975	37,541	110,125
1976	56,272	0
1977	35,179	0

Year	Other Deductions
1974	$169,168
1975	43,007
1976	2,337
1977	837

The interest deduction for 1974 was shown to have been paid to CFA. The cost or other basis for depreciation and investment credit purposes was shown as $1,450,000. Attached to the partnership returns are schedules K-1 showing the amounts of losses and the basis for investment credits passed through to the partner-petitioners.

CFA Investors VII - "How to Become a Movie Star"

CFA Investors VII was organized as a limited partnership in March 1974. According to an Amendment to the Certificate of Limited Partnership of CFA Investors VII, dated April 8, 1975, 14 individuals invested a total amount of $70,000 in the partnership. Polakof is the only partner who is a petitioner in this proceeding.

On December 1, 1974, CFA Investors VII entered into a contract of sale with CFA providing for the future production and sale by CFA of a film entitled "How to Become a Movie Star" (sometimes hereinafter "Movie Star"). The contract called for total payment by CFA Investors VII of $115,000, consisting of cash of $25,000 and a nonrecourse note for $90,000, bearing interest at the rate of 10 percent per annum and becoming due

and payable on December 31, 1981. The note was payable out of 50 percent of the net receipts from the film. Pursuant to the contract, CFA Investors VII made the $25,000 cash payment.

"How to Become a Movie Star" is a short subject 18-minute film which features Polakof asking questions of actors on how they broke into the movies. None of the actors were widely known. The film was not successfully distributed. It had a fair market value of zero for theatrical exhibition as well as network television and other ancillary purposes.

The following table shows the gross receipts, losses, depreciation, interest, and miscellaneous deductions reported by CFA Investors VII in partnership returns for 1974 through 1978:

Year	Gross Receipts	Losses
1974	100	41,546
1975	0	17,375
1976	0	0
1977	0	1,193
1978	0	237

Year	Depreciation	Interest
1974	$ 46	$ 9,000
1975	5,750	6,400
1976	0	0
1977	0	0
1978	0	0

Year	Other Deductions
1974	$ 32,600
1975	5,225
1976	0
1977	0
1978	0

For 1974, the miscellaneous deductions consist of a management fee of $25,000 and "mkt & dist" of $7,600. For 1975, the miscellaneous deductions include a flat $5,000 for travel and entertainment. Attached to the partnership returns are schedules K-1 showing the amounts of losses and the

basis for computing investment tax credits passed through to the partners.

Petitioners claimed deductions and investment credits based on the respective amounts shown for them on the schedules K-1 attached to the several partnership returns filed by the four partnerships. In the notices of deficiency issued to petitioners, respondent disallowed the deductions on several grounds. The notice of deficiency issued to Polakof contains the following "Explanation of Items:"

EXPLANATION OF ITEMS

(a) It is determined that the partnership loss claimed on your 1974 and 1975 returns for CFA Investors is not allowed because it has not been established that the acquisition of the movie was an activity entered into for profit. Additionally it is determined that the claimed partnership loss is disallowed for the following reasons:

The loss attributable to depreciation is disallowed because the fair market value of the film has not been established and therefore the loan to which the film is subject cannot be

considered as the partnership's liability and cannot be included in the partner's basis. Additionally, the loss deduction attributable to a part of the film's depreciation is disallowed because the non-recourse loan lacks economic substance and the amount of the loan cannot be added to the depreciable basis of the film. Also, it is determined that the partnership's method of depreciation does not bear a proper relationship to a decline in the film's usefulness.

The amount deducted as partnership loss attributable to interest expense, if paid, and further if paid for the purpose designated, was not in substance paid by the partnership. Furthermore, the purported loans received by the partnership do not constitute bona fide loans. Moreover, the loan cannot be added to the partner's basis.

The partnership loss attributable to the current deduction of management fees, and marketing and distribution expense are disallowed because it has not been established that these expenses were paid, and if paid, constitute ordinary and necessary business expenses and were expended for the purpose designated. Additionally, these costs are disallowed because these costs are expected to contribute substantially to the realization of income in subsequent years.

The notices of deficiency issued to the other petitioners contain basically similar explanations.

OPINION

At issue is the allowability of deductions taken by the several petitioners of the losses claimed by the four partnerships, CFA Investors I, CFA Investors IV, CFA Investors V, CFA Investors VII, for 1973 through 1977, and each petitioner's share of the claimed investment credit passed through the partnerships pursuant to section 1.46-3(a), Income Tax Regs.[8] The losses claimed by the partnership are attributable to deductions for rent, depreciation, management fees, interest,

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8 Sec. 1.46-3(a), Income Tax Regs., contains the following language: Section 38 property placed in service [for investment tax credit purposes] by the taxpayer during the taxable year includes the taxpayer's share of the basis (or cost) of section 38 property placed in service by a partnership in the taxable year of such partnership ending with or within the taxpayer's taxable year.***

and miscellaneous items such as advertising, distribution expense, travel expenses, and the like. In the main, the interest deductions are attributable to purported interest payments on the nonrecourse notes given by the partnerships as part of the alleged purchase price for the movies here at issue.

To qualify the management fees, rent, and miscellaneous deductions, petitioners have the burden of proving that the expenses were paid or incurred in carrying on a "trade or business" within the meaning of section 162(a).[9] The depreciation deductions turn on, among other things, whether the movie

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[9] SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General. -- There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.***

properties were "used" in a "trade or business" within the meaning of section 167(a)(1).[10] Under section 48(a)(1),[11] the investment credit is allowable only for "property with respect to which depreciation (or amortization in lieu of depreciation) is allowable."

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10 SEC. 167. DEPRECIATION:
(a) General Rule. -- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--
(1) of property used in the trade or business * * *.

11 SEC. 48. DEFINITIONS: SPECIAL RULES.
(a) Section 38 Property.--
(1) In general. -- Except as provided in this subsection, the term "section 38 property" means--
(A) tangible personal property * * * * *
Such term includes * * * property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more. * * *

Thus, petitioners' right to these deductions as well as the investment credit depends upon a showing that the activities from which the duductions arose constituted a "trade or business." See Flowers v. Commissioner [Dec. 40,112], 80 T. C. 914, 931 (1983); Pike v. Commissioner [Dec. 39,037], 78 T. C. 822, 841-842 (1982), affd. without published opinion 732 F. 2d 164 (9th Cir. 1984).

The allowability of the deduction for interest under section 163(a)[12] depends upon a showing that the nonrecourse notes constituted genuine indebtedness. Odend'hal v Commissioner [Dec. 39,992], 80 T. C. 588, 604-605

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12 SEC. 163. INTEREST.
(a) General Rule. -- There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(1983), affd. [84-2 USTC ¶ 9963] 748 F. 2d. 908 (4th Cir. 1984).

1. The Trade or Business Deductions

Essential to petitioners' showing that the four partnerships were engaged in a "trade or business" is a demonstration of an "actual and honest objective of making a profit." Dreicer v. Commissioner [Dec. 38,948], 78 T. C. 642, 646 (1982), affd. without opinion 702 F. 2d 1205 (D. C. Cir. 1983). While a reasonable expectation of profit is not required, the objective of making a profit must be bona fide. Allen v. Commissioner [Dec. 35,977], 72 T. C. 28, 33 (1979).

In the case of a partnership, the determination as to whether there was an actual objective of making a profit must be made at the partnership level.

Brannen v. Commissioner [84-1 USTC ¶ 9144], 722 F. 2d 695, 703-704 (11th Cir. 1984), affg. [Dec. 38,894], 78 T. C. 471 (1982); Goodwin v. Commissioner [Dec. 37,502], 75 T. C. 424, 437 (1980) affd. without published opinion 691 F. 2d 490 (3d Cir. 1982); Hager v. Commissioner [Dec. 37,905], 76 T. C. 759, 784 (1981). Because a limited partnership acts only through the general partner, we look to the actions of the general partner, CFA in this case, to determine whether the partnerships had a profit motive. Wildman v. Commissioner [Dec. 39,093], T. C. 943, 953-954 (1982); Siegel v. Commissioner [Dec. 38,962], 78 T. C. 659, 698-704 (1982).

As stated in our findings, the prospectus on each of the partnerships states that the partnership had two objectives: (1) "to maximize the distributed return on investors' capital"

and (2) "to provide investors with significant Federal Income Tax deductions in the first year through the vehicle of a feature length motion picutre: or, in the case of CFA Investors VII, "a documentary motion picture." Other parts of the prospectuses emphasize tax benefits beyond the first year.

A partnership activity does not constitute a trade or business unless the partnership engages in the activity with the predominant, primary or principal objective of making a profit. Flowers v. Commissioner, supra at 931; Siegel v. Commissioner, supra at 698; see also Hirsch v. Commissioner [63-1 USTC ¶ 9371], 315 F. 2d 731 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court [Dec. 25,021 (M)]; Lemmen v. Commissioner [Dec. 38,510], 77 T. C. 1326, 1340 (1981). We must, then decide whether realizing a return on the

investors' capital or providing the investors with tax benefits was the predominant objective of the partnerships. The resolution of this issue turns not on one factor alone but on the basis of all the facts and circumstances. Allen v. Commissioner, supra at 34; Jasionowski v. Commissioner [Dec. 33,828], 66 T. C. 312, 319, 321 (1976).

Some of the relevant factors to be considered in determining whether an activity is engaged in for profit are listed in section 1.183-2(b), Income Tax Regs.[13] In deciding whether making a

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13 Sec. 1.183-2. Activity not engaged in for profit defined.

(b) Relevant factors. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination.

profit was the predominant objective of the partnerships, greater weight is to be given to objective facts than to a mere

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13 In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making this determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) Manner in which the taxpayer carries on the activity. * * *

(2) The expertise of the taxpayer or his advisors. * * *

(3) The time and effort expended by the taxpayer in carrying on the activity. * * *

(4) Expectation that assets used in activity may appreciate in value. * * *

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. * * *

(6) The taxpayer's history of income or losses with respect to the activity. * * *

(7) The amount of occasional profits, if any, which are earned. * * *

(8) The financial status of the taxpayer. * * *

(9) Elements of personal pleasure or recreation. * * *

statement of a taxpayer's intent. Siegel v. Commissioner, supra at 696-698; Engdahl v. Commissioner [Dec. 36,167], 72 T. C. 659, 666 (1979).

Based on all of the evidence of record, we find that petitioners have not shown that the predominant purpose or objective of CFA, as general partner, was to make a profit on behalf of the partnerships. In reaching this conclusion, we have taken into full account the risks of losses inherent in making and marketing movies. We are convinced, however, that CFA's predominant primary or principal objective was to make money for itself and its owners as the promoters and to garner tax benefits for the limited partners. As limited partners, petitioners are not, therfore, entitled to deduct the partnership losses insofar

as they are attributable to the trade or business deductions.

A. CFA Grossly Overpriced the Motion Pictures. The partnership's purchase of the movies was not handled in a businesslike manner. Sec. 1.183-2(b)(1), Income Tax Regs. CFA sold the movies to the partnership at prices far in excess of their fair market value. There was no reasonable propect from the beginning that the movies would ever produce enough net revenue to permit the limited partners to recover their cash investment, let alone pay the nonrecourse notes and make a profit.

The following table summarizes and compares our findings as to the total prices paid for the movies, the cash payments, and the fair market values of the motion pictures:

Partnership-Movie	Stated Purchase Price
CFA I--"Silence"	$ 625,000
CFA IV--"He is My Brother"	1,425,000
CFA V--"Sunburst"	1,425,000
CFA VII--"Movie Star"	115,000

Partnership-Movie	Nonrecourse Note
CFA I--"Silence"	$ 500,000
CFA IV--"He is My Brother"	1,200,000
CFA V--"Sunburst"	1,200,000
CFA VII--"Movie Star"	90,000

Partnership-Movie	Cash Payment
CFA I--'Silence"	$ 125,000
CFA IV--"He is My Brother"	225,000
CFA V--"Sunburst"	225,000
CFA VII--"Movie Star"	25,000

Partnership-Movie	Total Value
CFA I--"Silence"	$ 30,000
CFA IV--"He is My Brother"	62,500
CFA V--"Sunburst"	25,000
CFA VII--"Movie Star"	0

In making our findings as to the fair market values of the motion pictures, we have adopted the valuations given in reports introduced throught the testimony of William Madden (Madden) and Robert Newgard (Newgard), both of whom are eminently qualified experts. After 25 years of sales work for Metro-Goldwyn Mayer studios, Madden served as the company's general sales manager and vice-president from 1969 to 1973. Newgard spent a career, from 1952 to 1980, buying or selling programs for television and has continued to work in this field. Both witnesses were able, well informed, objective, and reasonable in presenting their testimony and reports. Their opinions were not altered by cross-examination.[14]

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14 Petitioners offered expert testimony on the movies' values but we

These witnesses based their valuations on their judgment as to the marketability of each picture, taking into account such factors as the strength of the story, the ability and experience of the producer, director, and cast, the photography and music and sound as well as the costs of exploiting the films, including the costs of prints, advertising, and other marketing activities. We think their opinions as to values as of the dates the movies were bought and sold are reasonable. The complete lack of success in marketing any of the films indicates that their opinions were, indeed, generous.

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14 did not find it convincing in terms of the qualifications of the expert or in terms of the reasonableness of the conclusions.

The overpricing of the movies by CFA was made possible by the intimate relationship which existed between CFA as the general partner of the partnership which purchased the films and CFA (and Studio 16)[15] as the sellers of the films. Polakof as president, director, and stockholder of CFA dominated the whole scene. As a general partner, CFA "did not have any type of valuation made of the movie[s] prior to * * * [their] purchase by the partnership[s]." Brannen v. Commissioner [84-1 USTC ¶ 9144], 722 F. 2d 695, 704-705 (11th Cir. 1984), affg. [Dec. 38,894] 78 T. C. 471 (1982). The price of each movie was set in the respective partnership prospectuses long

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15 As stated in our findings, Studio 16 became a part of CFA when Denver Sutton brought its facilities to CFA. The two organizations may thus be treated as a single entity.

before the movie was made. Because CFA was both general partner and seller of the movies, there were no negotiations for more reasonable prices either before the contracts of sale were signed or after the movies were completed and realistic judgments could be made as to the movies' values. As a result, there was never any real prospect that the notes would be paid. See Barnard v. Commissioner [84-1 USTC ¶ 9372], 731, F. 2d 230, 231 (4th Cir. 1984), affg. sub nom. Fox v. Commissioner [Dec. 40,125], 80 T. C. 972 (1983).

Although this overpricing of the films helped doom the partnerships to financial failure, it was wholly consistent with the tax benefits that CFA promised the limited partners. As computed in the partnership returns, the partnerships' bases for depreciation of the movies and for investment tax credit

purposes included the amounts of the respective nonrecourse notes. Any reduction of the amounts of these notes would have decreased the tax benefits promised the investors in the several prospectuses. Had the nonrecourse notes been reduced substantially, CFA would not have been able to fulfill its promise to the CFA Investors IV limited partners of the equivalent of a 95-percent tax write-off in the first year.[16] Cf. Fox

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16 The statement on an investor's 95-percent first year tax write-off appears only in the prospectus for CFA Investors IV, but CFA Investors IV is not distinctive in terms of the tax benefits promised. All four of the partnerships follow the same pattern in otherwise describing the tax benefits. The record does not explain the absence of the representation in the other prospectuses. The following statement of the court of appeals in Barnard v. Commissioner [84-1 USTC ¶ 9372], 731 F. 2d 230, 231 (4th Cir. 1984), affg. sub nom. Fox v. Commissioner [Dec. 40,125] 80 T. C. 972 (1983), involving a book purchase tax shelter, is apposite:

v. Commissioner [Dec. 40,125[, 80 T. C. 972, 1006 (1983), affd. without publishing opinion 742 F. 2d 1441 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner [84-1 USTC ¶ 9372], 731 F. 2d 230 (4th Cir. 1984), affd. without published opinion sub nom. Kratsa v. Commissioner and Leffel v. Commissioner, 734 F. 2d 6 (3d Cir. 1984), affd. without published opinion sub nom. Hook v. Commissioner, 734 F. 2d 5 (3d Cir. 1984), affd. without published opinion sub nom. Rosenblatt v. Commissioner, 734 F. 2d 7 (3d Cir. 1984), affd. without published

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16 Summarily, the tax-minimizing scheme, an evasion not a mere avoidance of tax liability, was structured so that, if not a single copy of the book were ever marketed, nevertheless, the "deductions" generated for income tax purposes wold, for high bracket taxpayers * * *, be so great that they would, if the fabricated "deductions" were allowed, reduce taxes by a substantially greater amount than the relatively small sums contributed in cash * * * by each taxpayer.

opinion sub nom. Zemel v. Commissioner, 734 F. 2d 9 (3d Cir. 1984).

This large first year tax write-off was masde possible in large part by including the nonrecourse notes in the partnerships' bases for investment tax credit purposes. The promised avialability of the investment tax credit, an added tax benefit, was important in the promotion of the movie partnerships. It was not available for real estate investments. Polakof testified that many of the investors in these four partnerships werre individuals who had invested in his earlier real estate syndications. In his words, "Our investors felft that actually the return could be quicker than real estate." We intepret this testimony to refer to the tax benefits.

We think it is a reasonable inference that the partnerships' purchase

of the movies at prices (including the nonrecourse notes) far beyond their fair market values was an integral part of the plan for achieving the objective of providing tax benefits for the limited partners. The overpricing also benefited CFA to the extent of the cash payments it received; those payments were specified in the prospectuses and were not the subject of negotiations. We think the overpricing of the movies is inconsistent with an actual and honest objective of making a profit for the partnerships form the movies. Brannen v. Commissioner [Dec. 38,894], 78 T. C. 471, 508-509 (1982), affd. [84-1 USTC ¶ 9144] 722 F. 2d 695 (11th Cir. 1984); Estate of Baron v. Commissioner [Dec. 41,515], 83 T. C. 542 (1984).

B. The Prepayment of Interest and Management Fees Left the Partnerships Without Adequate Capital. Ordinarily,

when a new profit-motivated venture is undertaken, the entrepreneurs conserve available capital for use in carrying on the enterprise. CFA as general partner did just the opposite. It stripped the partnerships of much of their available capital by prepaying two major items: interest and management fees.

The prospectus for CFA Investors I states in part:

11. DUTIES AND COMPENSATION OF GENERAL PARTNER

A. Duties: During the life of the Partnership, CFA will furnish to the Partnership financial, marketing and operational counsel necessary to place the Partnership in a position to conduct the business for which it was formed and to accomplish the objectives of the Partnership.

B. Initial Non-Recurring Compensation: For the services described in Paragraph A above which relate to the start-up activities of the Partnership, CFA will receive a non-recurring start-up fee of $45,000.

The other prospectuses contain similar provisions except that for CFA

Investors IV and CFA Investors V, the start-up fee was $60,000 in each case; and for CFA Investors VII, the fee was $25,000. Provisions for these start-up management fees were carried forward into the executed contracts of sale. Polakof, who had been engaged in "marketing limited partnerships" involving real estate, explained that such management fees were "very traditional in the real estate field."

In addition, the prospectuses state that: "The Partnership may prepay and deduct in the year paid interest for a period not exceeding one year beyond the end of the taxable year in which the payment is made." As discussed above, those notes had no relationship to the movies; value and were uncollectible from the outset. Yet first-year interest on them was prepaid.

The following table shows the total amount invested in each partnership, the purchase price of its movie, the prepaid interest deducted, and the management fee in the first year:

Partnership	Total Investment	Cash Movie Price
CFA Investors I	$350,000	$ 125,000
CFA Investors IV	525,000	225,000
CFA Investors V	525,000	225,000
CFA Investors VII	70,000	25,000

Partnership	Prepaid Interest	Management Fee
CFA Investors I	$ 35,000	$ 45,000
CFA Investors IV	80,000	60,000
CFA Investors V	80,000	60,000
CFA Investors VII	9,000	25,000

As shown in our findings, the first partnership returns for CFA Investors I and VII report gross income of only $100. The first partnership returns for CFA Investors IV and V report gross income of only $50. These prepayments of management fees and

interest were thus made from captial and amounted to more than one-third of the capital remaining in each of the partnerships after making the cash payments for their respective movies. Indeed, in the case of CFA Investors VII, the prepayment of the management fee and interest in the nonrecourse note plus the cash payment for its movie, "Movie Star," left only $11,000 to cover all market, distribution, overhead, and related expenses. Significantly, as his reason for the partnerships' inability to finance the distribution and the eventual financial failure of "He is My Brother," "Sunburst," and "Movie Star," Polakof cited lack of sufficient capital.

The prepayment of the mangement fees and interest on the nonrecourse notes served the objective of providing large first-year tax deductions for the limited partners. These outlays, of

course, were deducted by the partnership and the partnership deductions figured in the partnership losses. Those losses were passed through to the limited partners and deducted on their individual returns. CFA was, of course, recipient and beneficiary of the payments.

Further, because the partnerships' nonrecourse notes were secured by the respective movies, CFA as holder of the notes became entitled, upon the partnerships' failure to pay the notes, to foreclose its liens. The utter impossibility of paying the notes removed any incentive for the limited partners to extend the partnerships beyond December 31, 1980. According to Polakof, CFA became owners of the movies, for whatever they may be worth. Polakof testified that he continues to receive small amounts of income from at least some of the movies.

The prepayment of interest and management fees thus contributed to the ultimate failure of the partnerships. Nonetheless, it served the tax-benefit interests of the limited partners as well as the financial interests of CFA and the partnership promoters.

C. The Lack of Experience of the Producers, Directors, and, in General, the Cast of the Movies Contributed to their Failure. The promoters of these four partnerships had no expertise in the production or distribution of feature-length movies. CFA, the general partner in all four partnerships, was not organized until 1973, the year in which all of the partnerships, excetp CFA Investors VII, were organized. CFA Investors Vii was organized later, in 1974. The organizers, shareholders, and officers of CFA were Polakof, president and chairman of the board; Reginald

Olsaen, executive vice-president; Ronald Peck, vice-president and treasurer; and Denver Sutton, vice-president. Polakof, Olsen, and Peck had been employed by an organization named Systech which was engaged in syndicating real estate partnerships. Sutton operated Studio 16 which had produced some short subject or documentary films. When CFA Investors I was being organized, Studio 16 had only a few "small jobs" and Polakof was able to arrange to use its facilities in producing the movies.

For the most part, the writer and directors and the cast, with one or two exceptions, were not experienced in making feature-length movies. This lack of experience showed up in the quality of the movies. In fact, Polakof instructed the staff working on "Silence" that quality was not important -- that having the movie shown before the end of the

year, for tax reasons, was the pressing concern. Further, because the movies were bought before they were produced, no one acting on behalf of the partnership had any control over the quality of the work.

According to credible expert testimony, distribution of a movie of poor quality, with no well known names connected with it, is extremely difficult. Theater owners have large numbers of pictures from which they make their selections for showing, and they tend to select films with producers, directors, and actors who are known to the public. Moreover, theater owners exchange information quickly on the public reaction to movies in different localities. This means that a poor response to a showing in one location makes it much more difficult to arrange a showing in another locality.

Polakof was evidently aware that the partnerships' movies would be difficult to market because he attempted to "four-wall" the first one, "Silence." The prospectuses indicate that a "multi-saturation" method of distribution was also planned for "He is My Brother" and "Sunburst." He apparently had the idea that any movie, regardless of its quality, could be successfully distributed with enough advertising.

Had Polakof and his associates consulted an expert of the caliber of William Madden, respondent's expert witness, they would have learned that the successful period of four-walling as a movie marketing method was the late 1960's and early 1970's. By 1974, the four-walling method was "practically finished," and this was "generally known to the industry." The dismal failure of CFA's efforts to four-wall "Silence" in

Los Angeles showed its weakness as a motion picture and confirmed Madden's opinion on the ineffectiveness of four-walling as a means of marketing the movies.

Polakof's insistence that "Silence" be finished without regard to quality so that it could be shown at leat once in 1973 is thus hardly consistent with a profit-making objective. It is perfectly consistent, however, with the objective of providing large first-year tax write-offs for the limited partners. As we have noted, the first-year partnership returns show gross income of $50 for each of two of the partnerships (CFA Investors IV and CFA Investors V) and $100 for each of the other two partnerships (CFA Investors I and CFA Investors VII). These small amounts of income were necessary in order to provide a basis for contending that the movies

were "placed in service" in the first year for investment tax credit purposes under section 48(a)(1) and were "used in a trade or business: in that year for depreciation purposes under section 167(a)(2); these small amounts of income likewise were apparently intended to show that the partnerships were "carrying on a trade or business" under section 162(a). CFA's disregard of the quality of the films is further evidence that the predominant purpose of the partnerships was not to make a profit, the partnerships was not to make a profit, but to provide tax benefits for the partners.

We are aware that CFA Investors I expended substantial sums in distributing "Silence" through four-walling procedures and had some receipts, first in Hawaii, then in Dallas, and finally in Los Angeles; a

small amount of the moneys used for this purpose was apparently borrowed from the Bank of America. These expenditures account for a considerable portion of the loss of $492,841 reported on CFA Investors I's partnership return for 1974. We note, however, that a $210,000 deduction for depreciation based mainly on treating the nonrecourse note as part of the partnership's basis for the movie is included in that loss. An exhibit analyzing the expenditures for 1974 also shows that a total amount of over $140,000 of the actual expenditures were classified under the general heading "Distribution and marketing services rendered." Polakof, Peck, and Olsen are shown as the recipients of a lion's share of the outlays for that purpose during the portion of the year for which individual payees are named. Had CFA Investors I's captial been conserved in a

business-like manner, the outside loans might not have been required.

Although the expenditures for four-walling "Silence" provide some evidence of a profit motive, we do not find such evidence sufficient to carry petitioner's burden. The prospectus on "Silence" makes the representation that the movie would be four-walled and uses it as a selling point. Polakof also made the point in his conversations with the director of the picture and the staff. The promoters thus obligated themselves to the investors to make the four-walling effort even though they may not have fully contemplated the magnitude of the losses that would be incurred. Had they consulted an expert in marketing films, such as Madden, they would have learned that successful four-walling was no longer probable in 1974 even with a strong film, and was virtually impossible

with a weak one like "Silence." CFA's failure to investigate the risks involved in the venture is further evidence of its failure to proceed in a businesslike manner. Sec. 1.183-2(b)(1), Income Tax Regs.; Surloff v. Commissioner [Dec. 40,419], 81 T.C. 210, 237 (1983).

2. Interest Deductions

Section 163(a) provides for the allowance of a deduction for "all interest paid or accrued within the taxable year on indebtedness." The cases are now legion, however, holding that, for the deduction to be allowable, the indebtedness must be genuine. If the purchase price and the principal amount of a nonrecourse note unreasonably exceed the value of the property to be purchased, then no genuine indebtedness exists. See, e.g., Estate of Franklin v. Commissioner [76-2 USTC ¶ 9773], 544 F. 2d 1045, 1048-1049 (9th Cir. 1976), affg.

[Dec. 33,359] 64 T. C. 752 (1975); Hager v. Commissioner [Dec. 37,905], 76 T. C. 759 (1981); Odend'hal v. Commissioner [Dec. 39,992], 80 T. C. 588, 604-605 (1983), affd. on this issue [84-2 USTC ¶ 9963] 748 F. 2d 908 (4th Cir. 1984); Brannen v. mmissioner [Dec. 38,894], 78 T. C. 471, 493 (1982), affd. [84-1 USTC ¶ 9144] 722 F. 2d 695 (11th Cir. 1984).

In the foregoing, we have contrasted the relatively minimal values of the four movies with the huge nonrecourse notes given CFA. That wide disparity demonstrates that the notes were not genuine indebtedness and the partnerships' claimed interest deductions are not allowable.

To reflect the foregoing, Decisions will be entered for the respondent.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES POLAKOF,
Petitioner-Apellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7581
T.C. No. 4777-80

ROY C. PETERSON,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7582
T.C. No. 13875-80

LEE E. SCHWARTZ and VERA J. SCHWARTZ,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7583
T.C. No. 20512-81

ROMAN J. and LORRAINE A. OLEYNIK,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7585
T.C. No. 29627-81

DAVID and FRANCES STEVENSON,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7586
T.C. No. 1764-82

ARLIN BLACKWELL and SHARON BLACKWELL,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7587
T.C. No. 1765-82

CLARENCE H. STEINHEBEL; GERTRUDE STEINHEBEL; MICHAEL A. BAKER; SUE B. BAKER; LEONARD A. VINCI; KEN B. TEAKLE; MARILYN L. TEAKLE; JOHN FERRERI; JUNE FERRERI; DEAN S. MERRICK; MARILYN MERRICK; FRANCES X. DRISCOLL; PATRICIA B. DRISCOLL,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 86-7312

T.C. No. 15666-81

OPINION

Argued and Submitted
January 14, 1987-San Francisco, California

Filed June 22, 1987

Before: Clifford Wallace, Otto R. Skopil, Jr. and William C. Canby, Jr., Circuit Judges.

Per Curiam

Appeal from the Decision of the United States Tax Court

SUMMARY

Taxation

Appeal from decision. Affirmed.

Petitioners are limited partners in one or more partnerships organized by Cinema Financial of America, Inc. (CFA) as general partner. The limited partnerships acquired feature-length motion pictures form CFA for distribution. Early investor tax benefits were a mojor selling point in CFA's offerings for partnership interest; acquisition was financed through large nonrecourse notes payable from a percentage of net distribution receipts. Each petitioner-taxpayer claimed distributive shares of losses and investments for tax credit purposes. The Commissioner of the Internal Revenue disallowed the taxpayers' claimed deductions, depreciation, and investment credits. On redetermination the Tax

Court held the write-offs improper and that the debts were not genuine.

(1) Petitioners contend that the actual objective of the film ventures was to make a profit. (2) It is the dominant economic motive of the partnership, not that of the individual investors, that is determinative. (3) These ventures were undertaken in an unbusinesslike manner. Large prepayments for CFA's services and of interest left the partnerships grossly undercapitalized. (4) The partnerships had no control over the quality, such as it was, of the finished films. (5) The Tax Court did not err in its determination that the primary purpose of the partnerships in buying the film properties was to create tax shelter, not to profit. (6) Reasoning that the amounts of the nonrecourse notes executed by each partnership greatly exceeded the films'

values, the Tax Court also held that petitioners' interest deductions were improper. This court agrees.

COUNSEL

John Gigounas and Edward B. Simpson, San Francisco, California for the petitioner-appellant.

Michael L. Paup and Theresa McLaughlin, Washington, D.C., for the respondent-appellee.

OPINION

PER CURIAM:

Petitioners are limited partners in one or more partnerships organized by Cinema Financial of America, Inc. (CFA) as general partner. The limited partnerships acquired feature-length motion pictures from CFA for distribution. Early investor tax benefits were a major selling point in

CFA's offerings for partnership interests; acquisition was financed through large nonrecourse notes payable from a percentage of net distribution receipts. Each petitioner-taxpayer claimed distributive shares of losses and investments for tax credit purposes.

The Commissioner of Internal Revenue disallowed the taxpayers' claimed deductions, depreciation, and investment credits. On redetermination,the Tax Court held the write-offs improper, concluding that the film activities were not undertaken for profit. Polakof v. Commissioner, 49 T. C. M. (CCH) 1300 (1985). Because the amounts of the nonrecourse notes given as partial consideration for the films greatly exceeded the films' values, the Tax Court further concluded that the debts were not genuine. Accordingly, the court

sustained the Commissioner's disallowance of interest deductions.

Twenty-three petitioners now appeal the Tax Court's decision. We affirm.

DISCUSSION

I. PROFIT MOTIVE

Petitioners contend that the actual objective of the film ventures was to make a profit.[1] We review for clear error the Tax Court's factual finding of whether an activity is undertaken for profit. E.g., Independent Electric Supply, Inc., v. Commissioner, 781 F.2d

[1] Petitioners must be engaged in a trade or business with an actual profit objective to qualify for deduction of ordinary and necessary expenses and depreciaton. Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963); Internal Revenue Code, 26 U.S.C. §§ 162(a), & 183(a) & (c). Investment credits may only be taken for depreciable (or amortizable) property. 26U.S.C. §§ 38 & 48(a)(1).

724, 727 (9th Cir. 1986). Petitioners bear the burden of proving profit motive. Id. [citing Bolaris v. Commissioner, 776 F.2d 1428, 1432 (9th Cir. 1985); Hirsch v. Commissioner, 315 F.2d 731, 738 (9th Cir. 1963)].

The Tax Court made its determination of profit motive at the partnership level, Polakof, 49 T.C.M. at 1307 (citing Brannen v. Commissioner, 722 F.2d 695, 703-04 (11th Cir. 1984), and examined the actions of CFA, the general partner, for their "predominant, primary or principal objective[s]."[2] Polakof, 49 T.C.M. (CCH) at 1308. The Tax Court concluded that CFA's predominant

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2 Petitioners contend that the Tax Court has impermissibly altered its standards for examining profit motive by moving from a "basic" or "dominant" purpose test to one of "predominant," "principal," or "primary" purpose. We reject any significant distinction between these terms as used in decisions of this court and the Tax Court.

motivation for actions taken on the partnerships' behalf was to garner tax benefits. Id. at 1308. This court has never decided whether the individual's or the partnership's intent governs.

(2) Petitioners do not dispute that partnership motive controls. We have previously suggested that examination of individual investor motivation would yield inconsistent tax treatment for parties engaged in joint activities. Independent Electric Supply, 781 F.2d at 729. Moreover, some investors with a dominant motive of tax avoidance legitimately join business activities that have a dominant profit objective. We agree with the Fifth and Eleventh Circuits that it is the dominant economic motive of the partnership, not that of the individual investors, that is determinative. Tallal v. Commissioner,

778 F.2d 275, 276 (5th Cir. 1985); Brannen, 722 F.2d at 702-04.[3]

Whether an activity is carried on for profit is determined by reference to objective standards and examination of all facts and circumstances. Independent Electric Supply, 781 F:2d at 726-27. "[O]bjective indicia may be cited to establish the taxpayer's true intent." Id. at 726 (citing Treas. Reg. §§ 1.183-2(a) & (b)(1972).

(3) These ventures were undertaken in an unbusinesslike manner. Large pre-payments for CFA's services and of interest left the partnerships grossly undercapitalized. With few exceptions,

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[3] The Seventh Circuit and several Tax Court decisions have also held that the issues of profit motive and the incurring of business expense must be resolved at the partnership level. Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 517 (7th Cir. 1980); see Brannen, 722 F.2d at 703 n.6 (citing cases).

personnel responsible for production and distribution had no feature film experience, and indication that successful marketing would be unlikely.[4]

(4) CFA personnel did, however, have extensive experience in tax shelter syndication. The terms and price for acquisition of each motion picutre were unilaterally set by CFA, the seller, without appraisal or reference to industry standards. The partnerships had no control over the quality, such as it was, of the finished films.

(5) The Tax Court did not err in its determination that the primary purpose of the partnerships in buying the

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[4] Similarly, the partnerships planned to use the unconventional and relatively expensive "four-wall" method for film distribution, in which the distributor rents the exhibiting theaters and assumes all advertising costs and responsibilities. This approach entailed large initial costs and contributed to CFA's economic failure.

film properties was to create tax shelters, not to profit. Respondent properly disallowed petitioners' expense deduction, depreciation, and investment credit claims.

II. INTEREST EXPENSE DEDUCTIONS

(6) Reasoning that the amounts of the nonrecourse notes executed by each parnership greatly exceeded the films' values, the Tax Court also held that petitioners' interest deductions were improper. We agree. See, e.g., Brannen, 722 F.2d at 701-02; Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048-49 (9th Cir. 1976).

Nonrecourse notes represented nearly three million dollars of the purchase price for the film properties. The partnerships never made payments on the notes. The Tax Court found that petitioners' evidence of fair market

value was contradictory and that their expert was unqualified. 49 T.C.M. (CCH) at 1309. In contrast, the Tax Court credited two briefer expert reports introduced by the Commissioner.[5]

Petitioners had the opportunity but failed to introduce stronger, more pertinent evidence of value.[6] Petitioners failed to demonstrate that the debts were

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[5] Respondent's reports credibly concluded that $30,000, $62,500, $25,000, and $0 were the market values of films with stated purchase prices of $625,000, $1,425,000, $1,425,000 and $115,000, respectively.

[6] Much of petitioners' lengthy report is written with an improper standard in mind. The proper inquiry focuses on the market value of the films at the time the partnerships were formed. See Smith v. Commissioner, 78 T.C. 350, 392 n.32 (1982) (subjective intent at time transaction was entered is determinative) [citing King v. United States, 545 F.2d 700, 709 (10th Cir. 1976)].

genuine.[7] See Independent Electric Supply, 781 F.2d at 727 [citing Hirsch, 315 F.2d at 738 (taxpayer has burden of showing that facts bring case squarely within deduction provisions; clearly erroneous standard applies)]. The Tax Court's acceptance of the Commissioner's experts and rejection of the reports offered by petitioners was not clearly erroneous. Disallowance of petitioners' interest deductions was proper. Knetsch v. United States, 364 U.S. 361 (1960); Deegan v. Commissioner, 787 F.2d 825 (2d Cir. 1986); Brannen, 722 F.2d at 701-2; Odend'hal v. Commissioner, 80 T.C. 588, 604-5 (1983), aff'd, 748 F.2d 908, 912

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[7] Consequently, the nonrecourse indebtedness cannot represent investment for purposes of determining depreciable adjusted basis. See generally Brannen, 722 F.2d 695; Estate of Franklin, 544 F.2d 1045; Narver v. Commissioner, 75 T.C. 53 (1980), aff'd per curiam, 670 F.2d 855 (9th Cir. 1982).

(4th Cir. 1984), cert. denied, 471 U.S. 1143; Narver v. Commissioner, 75 T.C. 53, 98 (1980), aff'd per curiam, 670 F.2d 855 (9th Cir. 1982); 26 U.S.C. § 163(a).

CONCLUSION

The decision of the Tax Court is AFFIRMED.[8]

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[8] Petitioners Steinhebel stipulated with the Commissioner to settle their claims before trial in the tax Court, and have moved to dismiss their entire appeal. The motion is granted and their appeal is dismissed. Claims for Bakers, Ferreris, Teakles, Merricks, and Vinci concerning participation in the CFA Investors IV partnership were similarly settled before trial. Accordingly, we do not rule upon those settled claims.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES POLAKOF,
Petitioner-Apellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7581
T.C. No. 4777-80

ROY C. PETERSON,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7582
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Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

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T.C. No. 20512-81

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Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7585
T.C. No. 29627-81

DAVID and FRANCES STEVENSON,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 85-7586
T.C. No. 1764-82

ARLIN BLACKWELL and SHARON BLACKWELL,
Petitioners-Appellants,

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Respondent-Appellee.

No. 85-7587
T.C. No. 1765-82

CLARENCE H. STEINHEBEL; GERTRUDE STEINHEBEL; MICHAEL A. BAKER; SUE B. BAKER; LEONARD A. VINCI; KEN B. TEAKLE; MARILYN L. TEAKLE; JOHN FERRERI; JUNE FERRERI; DEAN S. MERRICK; MARILYN MERRICK; FRANCES X. DRISCOLL; PATRICIA B. DRISCOLL,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 86-7312

T.C. No. 15666-81

AMENDED OPINION

Argued and Submitted
January 14, 1987-San Francisco, California

Filed June 22, 1987
Amended June 30, 1987

Before: Clifford Wallace, Otto R. Skopil, Jr. and William C. Canby, Jr., Circuit Judges.

Per Curiam

Appeal from the Decision of the United States Tax Court

SUMMARY

Taxation

Appeal from Tax Court

Judgement. Affirmed.

This action arises from a dispute over appellants' write-offs of losses involving their limited partnership in one or more partnerships organized by Cinema Financial of America (CFA) as general partner. The Tax Court concluded that CFA's film activities were not undertaken for profit.

(1) It is the dominant economic motive of the partnership, not that of the investors, that is determinative. (2) These ventures were undertaken in an unbusinesslike manner. With few exceptions, the personnel had no feature film experience. (3) They did, however, have extensive experience in tax shelter syndication. (4) Appellants failed to introduce sufficiently strong, pertinent

evidence of value of the nonrecourse notes they held. They failed to demonstrate that the debts were genuine.

COUNSEL

John Gigounas and Edward B. Simpson, San Francisco, California for the petitioner-appellant.

Michael L. Paup and Theresa McLaughlin, Washington, D.C., for the respondent-appellee.

OPINION

PER CURIAM:

Petitioners are limited partners in one or more partnerships organized by Cinema Financial of America, Inc. (CFA) as general partner. The limited partnerships acquired feature-length motion pictures from CFA for distribution. Early investor tax benefits were a major selling point in

CFA's offerings for partnership interests; acquisition was financed through large nonrecourse notes payable from a percentage of net distribution receipts. Each petitioner-taxpayer claimed distributive shares of losses and investments for tax credit purposes.

The Commissioner of Internal Revenue disallowed the taxpayers' claimed deductions, depreciation, and investment credits. On redetermination,the Tax Court held the write-offs improper, concluding that the film activities were not undertaken for profit. Polakof v. Commissioner, 49 T. C. M. (CCH) 1300 (1985). Because the amounts of the nonrecourse notes given as partial consideration for the films greatly exceeded the films' values, the Tax Court further concluded that the debts were not genuine. Accordingly, the court

sustained the Commissioner's disallowance of interest deductions.

Twenty-three petitioners now appeal the Tax Court's decision. We affirm.

DISCUSSION

I. PROFIT MOTIVE

Petitioners contend that the actual objective of the film ventures was to make a profit.[1] We review for clear error the Tax Court's factual finding of whether an activity is undertaken for profit. E.g., Independent Electric Supply, Inc., v. Commissioner, 781 F.2d

[1] Petitioners must be engaged in a trade or business with an actual profit objective to qualify for deduction of ordinary and necessary expenses and depreciaton. Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963); Internal Revenue Code, 26 U.S.C. §§ 162(a), & 183(a) & (c). Investment credits may only be taken for depreciable (or amortizable) property. 26U.S.C. §§ 38 & 48(a)(1).

724, 727 (9th Cir. 1986). Petitioners bear the burden of proving profit motive. Id. [citing Bolaris v. Commissioner, 776 F.2d 1428, 1432 (9th Cir. 1985); Hirsch v. Commissioner, 315 F.2d 731, 738 (9th Cir. 1963)].

The Tax Court made its determination of profit motive at the partnership level, Polakof, 49 T.C.M. at 1307 (citing Brannen v. Commissioner, 722 F.2d 695, 703-04 (11th Cir. 1984), and examined the actions of CFA, the general partner, for their "predominant, primary or principal objective[s]."[2] Polakof, 49 T.C.M. (CCH) at 1308. The Tax Court concluded that CFA's predominant

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2 Petitioners contend that the Tax Court has impermissibly altered its standards for examining profit motive by moving from a "basic" or "dominant" purpose test to one of "predominant," "principal," or "primary" purpose. We reject any significant distinction between these terms as used in decisions of this court and the Tax Court.

motivation for actions taken on the partnerships' behalf was to garner tax benefits. This court has never decided whether the individual's or the partnership's intent governs.

(1) Petitioners do not dispute that partnership motive controls. We have previously suggested that examination of individual investor motivation would yield inconsistent tax treatment for parties engaged in joint activities. Independent Electric Supply, 781 F.2d at 729. Moreover, some investors with a dominant motive of tax avoidance legitimately join business activities that have a dominant profit objective. We agree with the Fifth and Eleventh Circuits that it is the dominant economic motive of the partnership, not that of the individual investors, that is determinative. Tallal v. Commissioner,

778 F.2d 275, 276 (5th Cir. 1985); Brannen, 722 F.2d at 702-04.[3]

Whether an activity is carried on for profit is determined by reference to objective standards and examination of all facts and circumstances. Independent Electric Supply, 781 F.2d at 726-27. "[O]bjective indicia may be cited to establish the taxpayer's true intent." Id. at 726 (citing Treas. Reg. §§ 1.183-2(a) & (b)(1972).

(2) These ventures were undertaken in an unbusinesslike manner. Large pre-payments for CFA's services and of interest left the partnerships grossly undercapitalized. With few exceptions,

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3 The Seventh Circuit and several Tax Court decisions have also held that the issues of profit motive and the incurring of business expense must be resolved at the partnership level. Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 517 (7th Cir. 1980); see Brannen, 722 F.2d at 703 n.6 (citing cases).

personnel responsible for production and distribution had no feature film experience, and indication that successful marketing would be unlikely.[4]

(3) CFA personnel did, however, have extensive experience in tax shelter syndication. The terms and price for acquisition of each motion picutre were unilaterally set by CFA, the seller, without appraisal or reference to industry standards. The partnerships had no control over the quality, such as it was, of the finished films.

The Tax Court did not clearly err in its determination that the primary purpose of the partnerships in buying the

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4 Similarly, the partnerships planned to use the unconventional and relatively expensive "four-wall" method for film distribution, in which the distributor rents the exhibiting theaters and assumes all advertising costs and responsibilities. This approach entailed large initial costs and contributed to CFA's economic failure.

film properties was to create tax shelters, not to profit. Respondent properly disallowed petitioners' expense deduction, depreciation, and investment credit claims.

II. INTEREST EXPENSE DEDUCTIONS

Reasoning that the amounts of the nonrecourse notes executed by each parnership greatly exceeded the films' values, the Tax Court also held that petitioners' interest deductions were improper. We agree. See, e.g., Brannen, 722 F.2d at 701-02; Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048-49 (9th Cir. 1976).

Nonrecourse notes represented nearly three million dollars of the purchase price for the film properties. The partnerships never made payments on the notes. The Tax Court found that petitioners' evidence of fair market

value was contradictory and that their expert was unqualified. 49 T.C.M. (CCH) at 1309. In contrast, the Tax Court credited two briefer expert reports introduced by the Commissioner.[5]

(4) Petitioners had the opportunity but failed to introduce stronger, more pertinent evidence of value.[6] Petitioners failed to demonstrate that the debts were

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5 Respondent's reports credibly concluded that $30,000, $62,500, $25,000, and $0 were the market values of films with stated purchase prices of $625,000, $1,425,000, $1,425,000 and $115,000, respectively.

6 Much of petitioners' lengthy report is written with an improper standard in mind. The proper inquiry focuses on the market value of the films at the time the partnerships were formed. See Smith v. Commissioner, 78 T.C. 350, 392 n.32 (1982) (subjective intent at time transaction was entered is determinative) [citing King v. United States, 545 F.2d 700, 709 (10th Cir. 1976)].

genuine.[7] See Independent Electric Supply, 781 F.2d at 727 [citing Hirsch, 315 F.2d at 738 (taxpayer has burden of showing that facts bring case squarely within deduction provisions; clearly erroneous standard applies)]. The Tax Court's acceptance of the Commissioner's experts and rejection of the reports offered by petitioners was not clearly erroneous. Disallowance of petitioners' interest deductions was proper. Knetsch v. United States, 364 U.S. 361 (1960); Deegan v. Commissioner, 787 F.2d 825 (2d Cir. 1986); Brannen, 722 F.2d at 701-2; Odend'hal v. Commissioner, 80 T.C. 588, 604-5 (1983), aff'd, 748 F.2d 908, 912

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[7] Consequently, the nonrecourse indebtedness cannot represent investment for purposes of determining depreciable adjusted basis. See generally Brannen, 722 F.2d 695; Estate of Franklin, 544 F.2d 1045; Narver v. Commissioner, 75 T.C. 53 (1980), aff'd per curiam, 670 F.2d 855 (9th Cir. 1982).

(4th Cir. 1984), cert. denied, 471 U.S. 1143; Narver v. Commissioner, 75 T.C. 53, 98 (1980), aff'd per curiam, 670 F.2d 855 (9th Cir. 1982); 26 U.S.C. § 163(a).

CONCLUSION

The decision of the Tax Court is AFFIRMED.[8]

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[8] Petitioners Steinhebel stipulated with the Commissioner to settle their claims before trial in the tax Court, and have moved to dismiss their entire appeal. The motion is granted and their appeal is dismissed. Claims for Bakers, Ferreris, Teakles, Merricks, and Vinci concerning participation in the CFA Investors IV partnership were similarly settled before trial. Accordingly, we do not rule upon those settled claims.

PROOF OF SERVICE

I, Gina R. Nazarek, delcare:

I am employed in the City and County of San Francisco, State of California. I am over the age of eighteen years and not a party to nor interested in the within action; my business address is 50 California Street, Suite 2450, San Francisco, California 94111. On September 21, 1987, I served one true copy of the within PETITION FOR CERTIORARI by placing it in a sealed envelope with postage thereon fully prepaid, in the United States mail at San Francisco, California addressed as follows:

Solicitor General
Department of Justice
Washington, D.C. 20530

I declare under penalty of perjury that the foregoing is true and correct.

Executed on this 21st day of September, 1987 at San Francisco, California.

Gina R. Nazarek

Gina R. Nazarek

Supreme Court, U.S.
FILED
DEC 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-529

In the Supreme Court of the United States

OCTOBER TERM, 1987

JAMES POLAKOF, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners contend in this tax shelter case that the court of appeals erred in upholding the Tax Court's finding that the acquisition and distribution of motion pictures by their partnerships were activities not engaged in for profit because the partnerships lacked a "predominant" profit motive.

1. Petitioners are limited partners in one or more of four limited partnerships, which were organized by general partner Cinema Financial of America, Inc. (CFA) to acquire and distribute feature-length motion pictures.[1] Each partnership agreed, in advance of production, to acquire a film to be produced by a CFA affiliate for a cash down payment plus a nonrecourse note payable solely

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[1] A list of the various partnerships, and petitioners' respective interests in them, is set forth in the opinion of the Tax Court (Pet. App. A15 n.5, A22 n.6, A26 n.7, A29).

from the net proceeds of the distribution of the film.[2] The prices of the films were established in the partnership prospectuses and were not negotiated (Pet. App. A48-A49, A75-A76).

Early investor tax benefits were a major selling point in CFA's offerings for partnership interests. The offering materials prepared by CFA devoted several paragraphs to explaining the income tax benefits of the investment (see Pet. App. A11-A13). They also explained that the respective partnerships' payments to CFA might include prepayments of interest, management fees, and other costs of promotion and distribution, in addition to the price of the film (*id.* at A14). The films were box office failures (see *id.* at A47, A58). No cash distributions were made by the partnerships to petitioners, and no payments were ever made with respect to the principal of the nonrecourse notes (*id.* at A14-A15).

For each of the years in issue (ranging variously from 1973 to 1977), petitioners claimed on their individual income tax returns their distributive shares of the investment tax credit and the expenses incurred by the partnerships in acquiring and distributing the films. On audit, the Commissioner disallowed the claimed deductions and credits on the grounds that the partnerships' movie distribution activities were activities "not engaged in for profit" within

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[2] The purchase prices for the movies were as follows: (1) *Silence*, $625,000, consisting of $125,000 in cash and a nonrecourse note payable to CFA in the amount of $500,000 (Pet. App. A16); (2) *He Is My Brother*, $1,425,000, consisting of $225,000 in cash and a nonrecourse note payable to CFA in the amount of $1,200,000 (*id.* at A22); (3) *Sunburst*, $1,425,000, consisting of $225,000 in cash and a nonrecourse note payable to CFA in the amount of $1,200,000 (*id.* at A26); and (4) *How to Become a Movie Star*, $115,000, consisting of $25,000 in cash and a nonrecourse note payable to CFA in the amount of $90,000 (*id.* at A29).

the meaning of Section 183(a) of the Internal Revenue Code.[3] The Commissioner also concluded that no interest deductions were allowable because the nonrecourse notes did not constitute genuine debt. Pet. App. A32-A33.

Petitioners sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's determinations (Pet. App. A1-A69). The court, weighing expert testimony, found that the partnerships acquired the films at grossly inflated prices (*id.* at A44), due primarily to CFA's affiliation with the producers (*id.* at A48) and in part to the fact that the prices had not been subject to negotiation (*id.* at A49). The court observed that, in any event, there was no incentive to bargain over the film prices because the tax benefits advertised to investors increased directly with the amount of the nonrecourse debts, and the notes were payable only from distribution proceeds, if any (*id.* at A50). Since the court found that CFA exhibited a general disregard for production quality (*id.* at A60-A61), seriously depleted partnership capital by prepaying interest and management fees to itself (*id.* at A53-A54), used the expensive and risky "four-walling" method of distributing one film when the industry had generally abandoned the technique (*id.* at A67), and had no personnel with any prior experience in motion picture distribution (*id.* at A59-A60), the court concluded that the entire operation had been conducted in an extremely unbusinesslike manner and was not designed to make a profit (*id.* at A43-A44). Observing that there was "no reasonable prospect from the beginning that the movies would ever produce enough net revenue to permit [petitioners] to recover their cash investment, let alone pay the nonrecourse notes and make a profit," the court inferred that the scheme was designed primarily "to garner tax benefits" for petitioners (*ibid.*).

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

With respect to the interest deductions, which are available even to taxpayers who are not engaged in a trade or business for profit (see I.R.C. § 183(b)(1)), the Tax Court disallowed the claimed deductions because it found that the nonrecourse notes were not genuine indebtedness (Pet. App. A68-A69). The court reasoned that, because the amounts of the nonrecourse notes bore "no relationship" to the films' respective fair market values (*id.* at A55), there was no economic incentive to pay off the notes. Accordingly, the court concluded that those obligations did not constitute genuine indebtedness for which interest deductions are allowable (*id.* at A69).

3. The court of appeals affirmed (Pet. App. A70-A100). The court, observing that the question whether an activity is carried on for profit "is determined by reference to objective standards and examination of all facts and circumstances" (*id.* at A80), upheld as not clearly erroneous the Tax Court's finding that "the primary purpose of the partnerships in buying the film properties was to create tax shelters, not to profit" (*id.* at A81-A82). The court of appeals also upheld the Tax Court's conclusion that petitioners were not entitled to interest deductions claimed with respect to the nonrecourse notes because the amounts of those notes "greatly exceeded the films' values" (*id.* at A82).

4. Petitioners contend that the partnerships' acquisition and distribution of the films were in fact activities engaged in for profit (Pet. 17-24) and that the interest paid on the nonrecourse notes should be deductible (*id.* at 24-25). These factbound contentions were correctly rejected by both courts below. The court of appeals' decision does not conflict with any decision of this Court or of any other court of appeals. Accordingly, there is no reason for review by this Court.

a. Petitioners' basic contention (Pet. 17-25) is that the courts below applied an incorrect standard to the "profit motive" inquiry in requiring the partnerships to demonstrate that their "predominant, primary or principal" purpose in acquiring and distributing the films was to derive a profit. Petitioners advance little support for this proposition. Whether or not they use the precise word "predominant," the courts of appeals that have addressed the issue have generally agreed that the "profit motive" must be dominant in order to render expenses deductible as trade or business expenses, and no court of appeals has rejected that standard. See, *e.g.*, *Simon* v. *Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987); *Thomas* v. *Commissioner*, 792 F.2d 1256, 1259 (4th Cir. 1986); *Independent Electric Supply, Inc.* v. *Commissioner*, 781 F.2d 724, 726 (9th Cir. 1986); *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985); *Brannen* v. *Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984); *Eastman* v. *United States*, 635 F.2d 833, 837 (Ct. Cl. 1980).[4] Indeed, this Court has recognized the general applicability of this approach, stating that "[t]he standard test for the existence of a trade or business for purposes of Section 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.' " *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986), (quoting *Brannen* v.

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[4] Petitioners rely (Pet. 23) upon *Johnson* v. *United States*, 11 Cl. Ct. 17 (1986), where the Claims Court found that "a primary or dominant standard is not appropriate in the business setting" (*id.* at 26). This Claims Court decision plainly does not establish a conflict in the circuits and provides no basis for review by this Court. In any event, we note that, even under the test posited by petitioners and the Claims Court, the Tax Court's findings here are inconsistent with holding the partnerships' activities to be "for profit." The Tax Court found that the overpricing of the films "doom[ed] the partnerships to financial failure" (Pet. App. A49) and that it was "inconsistent with an actual and honest objective of making a profit" (*id.* at A53). Petitioners offer no reason for doubting the correctness of these findings.

Commissioner, 722 F.2d at 704). Accordingly, there is no reason for this Court to disturb the conclusion of both courts below that the partnerships' activities were not for profit.

b. Petitioners also contend (Pet. 24-25) that the courts below erred in denying them deductions for interest paid with respect to the nonrecourse notes. The only basis offered for this contention is the assertion (*ibid.*) that "application of the incorrect profit motive standard prejudiced the Courts [*sic*] view of the * * * indebtedness." It is not evident what the connection is between these two issues, but, in any event, the courts did not apply an incorrect standard to the profit motive inquiry (see point 4a, *supra*). The courts below simply adhered to the well-settled principle that nonrecourse notes that do not represent genuine indebtedness yield no interest deductions. See, *e.g.*, *Estate of Baron* v. *Commissioner*, 798 F.2d 65, 68 (2d Cir. 1986); *Odend'hal* v. *Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985). There is no basis for this Court to overturn their shared conclusion on this factual issue. See *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573-574 (1985).

It it therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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